

Message Text

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FM SECSTATE WASHDC

TO AMEMBASSY NAIROBI PRIORITY

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FOR SECRETARY SHULTZ AND UNDER SECRETARY VOLCKER,
USDEL IMF/IBRD ANNUAL MEETING

SUBJ: PROPOSED LETTER TO CONGRESS ON IET EXEMPTION

1. AS AGREED PRIOR VOLCKER DEPARTURE FOR NAIROBI,
FOLLOWING IS PROPOSED TEXT OF LETTER TO BE SENT TO
WILBUR MILLS FROM WILLIAM SIMON AS ACTING SECRETARY
IN FULFILLMENT OF CONGRESSIONAL REQUIREMENT FOR A REPORT
ON CANADIAN IET EXEMPTION BY SEPTEMBER 30. (LETTER
WOULD ALSO BE SENT TO SENATOR LONG.)

2. BEGIN TEXT. QUOTE PURSUANT TO SECTION 4 OF PUBLIC LAW 93-17,
APPROVED APRIL 10, 1973, THE TREASURY DEPARTMENT
HAS CONDUCTED A STUDY CONCERNING THE
CANADIAN EXEMPTION FROM THE INTEREST EQUALIZATION TAX.
EXECUTIVE ORDER 11175 OF SEPTEMBER 2, 1964, AS AMENDED
BY EXECUTIVE ORDER 11314 OF SEPTEMBER 12, 1966,
PROVIDES FOR AN EXCLUSION FROM THE IET FOR ORIGINAL OR
NEW CANADIAN ISSUES OF STOCK OR DEBT OBLIGATIONS. THIS
EXCLUSION IS BASED UPON A DETERMINATION, UNDER SECTION 2
OF THE INTEREST EQUALIZATION TAX ACT APPROVED
SEPTEMBER 2, 1964, (PUBLIC LAW 88-563) THAT THE
APPLICATION OF THE TAX WOULD HAVE "SUCH CONSEQUENCES FOR
CANADA AS TO IMPERIL OR THREATEN TO IMPERIL THE STABILITY
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OF THE INTERNATIONAL MONETARY SYSTEM."

SINCE 1964, CANADA HAS MOVED FROM A FIXED EXCHANGE RATE SYSTEM TO A FLOATING SYSTEM AND THERE HAVE BEEN MANY OTHER SIGNIFICANT DEVELOPMENTS AFFECTING THE INTERNATIONAL MONETARY ENVIRONMENT. THE CASE FOR THE CANADIAN EXEMPTION IN THESE CHANGED CIRCUMSTANCES IS NOT AS COMPELLING AS IT WAS AT THE TIME IT WAS FIRST ESTABLISHED. NEVERTHELESS, I HAVE CONCLUDED THAT SUFFICIENT JUSTIFICATION CONTINUES TO EXIST, WITHIN THE REQUIREMENTS OF THE INTEREST EQUALIZATION TAX ACT, AS AMENDED, FOR CONTINUING THE EXCLUSION FOR CANADA. THE PRINCIPAL REASONS INCLUDE THE FOLLOWING:

1) THE UNITED STATES AND CANADIAN ECONOMIES AND FINANCIAL SYSTEMS CONTINUE TO BE CLOSELY INTERRELATED. A MAJOR ACTION, SUCH AS ELIMINATION OF THE IET EXEMPTION, WOULD CREATE SUBSTANTIAL DISTURBANCES TO THE PRESENT STRUCTURE OF THE FINANCIAL LINKS BETWEEN OUR TWO COUNTRIES.

2) TO THE EXTENT THAT IMPOSITION OF THE IET RESTRAINT ON CAPITAL FLOWS FROM THE UNITED STATES TO CANADA WOULD REDUCE THE SUPPLY OF U.S. DOLLARS FOR CONVERSION INTO CANADIAN CURRENCY, THE CANADIAN DOLLAR'S QUOTATION IN TERMS OF THE U.S. DOLLAR WOULD TEND TO DEPRECIATE UNDER CANADA'S FLOATING EXCHANGE RATE REGIME. SUCH A DEVELOPMENT WOULD BE CONDUCIVE TO A FURTHER INCREASE IN THE ALREADY LARGE BILATERAL TRADE DEFICIT THAT THE UNITED STATES HAS WITH CANADA.

3) THE ELIMINATION OF THE CANADIAN EXEMPTION WOULD BE LIKELY TO GENERATE IMPORTANT SHIFTS IN THE DIRECTION OF INTERNATIONAL CAPITAL MOVEMENTS AS CANADIAN BORROWERS WOULD SEEK TO FIND SUBSTITUTE SOURCES OF FUNDS IN INTERNATIONAL MARKETS. IN THE PRESENT TRANSITIONAL PHASE BETWEEN AN OLD AND A NEW INTERNATIONAL MONETARY SYSTEM WE HAVE SEEN THAT DEVELOPMENTS INDUCING SIGNIFICANT CHANGES IN THE PATTERN OF CAPITAL FLOWS CAN EASILY GENERATE UNCERTAINTIES AND UNSETTLING PRESSURES ON THE EXCHANGE MARKETS. I BELIEVE IT WOULD NOT BE PRUDENT TO ADD TO SUCH RISKS.

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IN ADDITION TO THESE CONSIDERATIONS, I AM MINDFUL OF OUR COMMITMENT TO PHASE OUT THE IET AND THE OTHER RESTRAINTS ON UNITED STATES CAPITAL OUTFLOWS NO LATER THAN THE END OF 1974. PLACING AN IET BARRIER BETWEEN THE U.S. AND CANADA FOR SUCH A RELATIVELY SHORT PERIOD WOULD CREATE UNWARRANTED INTERFERENCE WITH THE RELATIONSHIPS THAT HAVE BEEN BUILT UP OVER THE YEARS BETWEEN

CANADIAN BORROWERS AND U.S. LENDERS. CANADIAN PROVINCES
AND OTHER TRADITIONAL USERS OF U.S. FUNDS WOULD BE
FORCED TO REASSESS THEIR PLANS AND PROCEDURES AND U.S.
LENDERS AND FINANCIAL INTERMEDIARIES WOULD LOSE
OPPORTUNITIES THAT MIGHT BE DIFFICULT TO RECAPTURE IN THE
FUTURE. FINALLY, IN THE LIGHT OF THE POLICY DECISION
TO TERMINATE THE IET, IT WOULD BE INCONGRUOUS TO ACT AT
THIS LATE DATE IN A CONTRADICTORY DIRECTION BY REMOVING
AN EXEMPTION FROM A TAX THAT WE ARE DETERMINED TO
ELIMINATE.

I AM SENDING A SIMILAR LETTER TO SENATOR RUSSELL
B. LONG, CHAIRMAN OF THE SENATE FINANCE COMMITTEE.

UNQUOTE END TEXT

3. PLEASE CABLE APPROVAL WITH ANY CHANGES.
RUSH

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